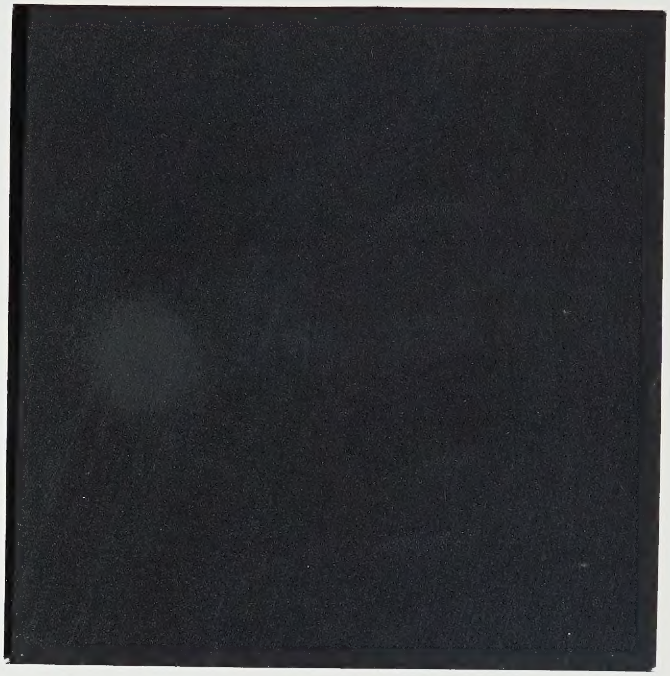
SMALL BUSINESS ADVOCACY
REPORT NO. 11

NEW VENTURES: A LOAN GUARANTEE PROGRAM FOR NEW BUSINESSES IN ONTARIO

June, 1986

MINISTRY OF INDUSTRY, TRADE AND TECHNOLOGY
ONTARIO



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June, 1986

Small Business Branch
Small Business, Service Industries
and Capital Projects Division
Ministry of Industry, Trade and
Technology

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Objective

To encourage and develop entrepreneurial activity and job creation by providing new business owners with loans of up to $15,000 guaranteed by the government of Ontario.

Eligibility

1. Persons aged 18 and over who are residents of Ontario.
2. Applicants must provide capitalization in their business at least equal to the approved loan (e.g. a personal commitment of $15,000 against a $15,000 loan). This matching capital must be in the form of cash.
3. Applicants must be eligible to work in Canada.
4. Businesses must plan to hire at least one employee in addition to the owner during the term of the loan guarantee.
5. Businesses must be registered in Ontario and begin operations within four weeks of receiving the loan.

Benefits

The anticipated results for each year of operation are:

- 7,000 firms assisted;
- 10,500 incremental jobs;
- $315 million incremental sales;
- $105 million private lender financing;
- $22 million incremental provincial revenue

The program will develop self-discipline among participating business owners through strong emphasis on business planning at the application stage and financial reporting through the term of the loan. Measurable improvement in the survival and growth of new firms will result from the linkage of better access to capital and management upgrading.

Special Features in the North and East

To improve access to New Ventures loans in Northern and Eastern Ontario the program will feature:

- $25 million in loans set aside for these regions;
- Owner's equity requirement reduced to 50% (e.g., $7,500 personal commitment against a $15,000 loan);
- Provincial guarantee period of 48 months, compared to 36 months in the rest of Ontario;
- Special promotion of the program and selection of regional lenders.

Benefits of the special features for Northern and Eastern Ontario each year are:

- 1,700 firms assisted;
- 2,550 incremental jobs;
- $76 million incremental sales.

Nature of Loan and Collection Procedures

For the first 12 months, participants will pay interest only at the rate of prime plus 1%. After one year, repayment will begin with at least 60% of repayment to be completed within the next 24 months, the end of the guarantee period. In the North and East, the guarantee will extend for an additional 12 months and 90% of the loan will have been repaid by the end of the period. At that point lenders and participants will negotiate terms of the loan and repayment on a market basis.

The lenders will be responsible for collection procedures during the loan guarantee period. Throughout this time the interest rate will be maintained at prime plus 1%.

The government will reimburse the lenders for any defaulted principal and interest payments during the guarantee period. The Ministry will refer all loans not paid during the guarantee period to the government's Central Collection Service.

Roles of the Co-sponsors

Approved Lenders (Chartered Banks, Trust Companies,Credit Unions and Caisses Populaires):

- Accept completed applications, interview applicants, review business proposals, and approve loan applications in accordance with guidelines.
- Issue loans and report to Ontario government.
- Monitor of approved business through a review process.
- Loan administration and collection during the guarantee period.
- Provide banking advice to participants.

Ontario Chamber of Commerce, Local Chambers of Commerce, Boards of Trade, and Business Associations:

- Consult in program design and delivery.
- Disseminate information and applications and promote program in their own communities.

Ministry of Industry, Trade and Technology:

- Design, promote, and administer overall program.
- Design, print and distribute application packages and related forms.
- Monitor loan applications, approvals and business status.
- Guarantee loans and reimburse lenders for interest and default costs.
- Co-ordinate education for participants and follow-up sessions with local Chambers and Boards.
- Follow up and evaluate results.

Lender Administration Fee

Lenders will receive a fee for the administrative efforts involved in accepting applications, interviewing applicants, and monitoring businesses. The following schedule is proposed:

- $30 screening fee for each application assessed (applicants interviewed).
- $150 for each loan approved by the government.

Successful loan applicants will pay a $150 administration fee to the Ministry, which may be deducted from the principal and remitted when the loan is advanced.

Costs

The program will cost $12,400,000 in the first year of operation, based on issuing 7,000 loans with a total principal of $105,000,000. Based on an estimated 10% annual default rate (11% in the North and East), costs stabilize in the fourth year of the program at about $37,000,000.

NEW VENTURES
LOAN GUARANTEE PROGRAM FOR NEW BUSINESSES IN ONTARIO

I INTRODUCTION

Access to capital is the most pressing financial problem of newly-formed small businesses. In response, both federal and provincial governments have adopted specific indirect measures in the tax arena to address the equity capital needs of start-ups and young companies. The focus of these measures has been the estimated 20 per cent to 30 per cent of young firms less than five years old constrained in their growth or threatened by failure as a result of a shallow equity base. This group includes between 7,500 and 10,000 new businesses yearly.

The New Ventures Program is a direct measure aimed to help overcome market barriers to capital. It will take advantage of the evident readiness of lenders to cooperate in the field of small business lending and the success of similar initiatives by the government of Ontario.

A. Access to Capital

Business owners use their own money for most of the start-up investment. The primary source for the balance of start-up funds is banks and other financial institutions. Yet many small business owners face serious barriers to obtaining commercial credit:

- Lack of proven business skills
- Lack of bankable assets or collateral
- Lack of a satisfactory business plan

Some lenders have recognized these barriers and taken initiatives to help overcome them. The Royal Bank, for example, has cooperated with the Ontario Government in guaranteed lending to young entrepreneurs through the Student Venture Capital and Youth Venture Capital programs.

The Canadian Imperial Bank of Commerce has directly targetted women business owners, recognizing that women, "despite their success in business have often been excluded from equal access to business expertise and capital." As an extension of the CIBC's policy of equal access to credit for women and men, the bank has initiated seminars for women business owners across the country.

B. Small Business Lending

Despite these positive initiatives, bank performance in the small business arena is not without problems. Many small business owners feel that there is a lack of competition in financial services. This is contrasted to the United States where thousands of banks compete aggressively. In Canada, trust companies are marginal participants in commercial lending and a 7 per cent ceiling is placed on the proportion of assets in this type of business. The situation is comparable to the residential mortgage market a decade ago when chartered banks were restricted from competing in that sector.

The banks tend to be cautious in small business lending. Loans must be secured by physical assets, collateral worth more than twice the value of the loan or personal guarantees and property. The resistance to lending against non-tangible assets such as owner/manager skills is well known. Unfortunately, this does not correspond to the pattern of new business formations. Over 90 per cent of new businesses are in the service and retail fields which frequently lack hard assets.

A mechanism is needed to improve the access to capital for new firms in businesses which are rich in job creation but poor risks in the eyes of bank credit managers. The problem is particularly acute for women and young entrepreneurs. Any measure to improve access to capital should assist banks and other financial institutions to address the special needs of these groups.

II. STRATEGY

The New Ventures Program program has emerged as the preferred strategy following consideration of three alternatives.

1. **Help for Entrepreneurs Loan Program (HELP)**
   Ontario Development Corporation

   HELP is a recent program of ODC designed to provide small loans to new firms with streamlined administration and rapid approval. Loans are given in a series of steps: up to $5,000 for start-up; $5,000 - $15,000 for expansion; and up to $35,000 for final stage.

   Pro

   - delivers small loans quickly
   - can be focussed on start-ups
   - provides visible, direct government assistance

   Con

   - adds to debt burden of the small business
   - only available to manufacturers, tourism and related firms
   - reaches small number of firms (about 600 per year)
   - uses direct government funds
   - not targetted to jobs
   - costly administration

2. **Small Business Loans Act (SBLA)**

   SBLA is federal legislation which guarantees chartered bank loans up to $100,000 for small companies buying land, building facilities and acquiring or upgrading equipment.

   Pro

   - all types of businesses are eligible
   - no cost to Ontario
   - helps existing businesses

Con

- loans must be fully secured by collateral
- working capital is <u>not</u> a permitted use of funds.
- no business planning and counselling features.

3. **New Ventures Program**

Would guarantee loans up to $15,000 by private sector lenders such as banks, trust companies and credit unions to new small businesses. A matching equity contribution by the business owner would be required.

Pro

- lenders support the concept and are willing to participate
- provides loans to all types of businesses
- helps start-up of new businesses.
- permits non-asset based lending
- includes business planning and follow-up support
- targetted to job creation.
- special features for the North and East

Con

- an add-on cost in addition to existing programs
- adds to debt burden of the business owner

Recommended Strategy

The New Ventures Program is the recommended strategy. It will make a strong contribution to achieving the objective of improving small business access to capital. It will have broad appeal in the small business community and promote job creation.

In summary, the proposal has the following advantages:

- It encourages entrepreneurship and the formation of new businesses, increasing economic activity and generating many "spin-off" benefits, especially in the area of employment. The majority of new jobs in Ontario are being created by small businesses.

- The educational and follow-up aspects of the program will develop participants' entrepreneurial skills and help prevent a major cause of small business failure - poor planning and management.

- The program will benefit the majority of entrepreneurs who are not eligible for Ontario's Youth and Student Venture Capital Programs. It will also benefit the 20 per cent of new owner-managers who are women.

III. PROGRAM ELEMENTS

A. Design Features

The following design features are integrated in the program:

1. **Job Creation Requirement.**

   Eligibility for the New Ventures Program will be tied to job creation, requiring at least one new job per firm. This is consistent with designating the target group as owner-operated firms that hire employees rather than self-employment enterprises.

2. **Percentage Equity Required.**

   The proposed level requires participants to contribute equity to match the loan amount at a level considerably higher than the 20 per cent set under the Youth Venture Capital Program. Dollar for dollar equity will be required except in Northern and Eastern Ontario. Greater equity contribution by the participant improves the chance of survival and commitment to the project by the owner.

3. **Maximum Loan Amount.**

   Setting the maximum loan at $15,000 is based on studies of new owner-managed firms that show average investment from the owner's own resources is currently in this range. Thus, the program will roughly double available capital.

4. **Percentage of Loan Insured.**

   Like the Student and Youth Venture Capital Programs, the New Ventures program will insure up to 100 per cent of the value of the loan. Considering the lack of collateral requirements this is necessary to secure lender participation.

5. **Age of Firm.**

It is proposed that only start-up firms be eligible. Start-up firms are responsible for most small business job creation. They are also most likely to benefit from the program's business planning features.

6. **Impact on Women**

Women currently make up 19 per cent of the people starting new firms with employees. It is likely that women business owners face additional difficulties in raising capital. Certainly it is known that the initial equity in female-owned businesses is less than for men. Thus, the program will particularly benefit women starting new ventures.

To achieve this impact promotional funds will be specifically earmarked to bring the program to the attention of women. In addition, it appears feasible to set targets to achieve strong female participation in the program. That could be expressed as a minimum of 25% of loans in the first year, rising to a minimum of 30% in the third year.

7. **Northern and Eastern Ontario**

To ensure that the New Ventures Program delivers strong benefits to Northern and Eastern Ontario, loan funds will be specially designated and set aside. Of the $105 million private lender financing to be guaranteed yearly, $25 million will be reserved for Northern and Eastern Ontario businesses. Specific promotion of New Ventures in the North and East will be a feature of the program.

Recognizing the need for special measures to facilitate access to capital, the program's equity matching requirements in the North and East will be different than in the rest of the Province. Rather than dollar for dollar personal equity against the loan amount, applicants will be required to invest at least 50% of the loan amount in the new business (e.g., a personal stake of $7,500 and a $15,000 loan).

Reducing the equity matching requirements is anticipated to make these loans somewhat riskier in the eyes of lenders. Accordingly, the guarantee period will be extended 12 months, at which point 90% of the loan will have been repaid.

B. Eligibility Criteria

1. Persons aged 18 and over who are residents of Ontario.

2. Applicants must provide capitalization in their business equal to the approved loan (e.g. a personal commitment of $15,000 against a $15,000 loan), except in Northern and Eastern Ontario. This matching capital must be in the form of cash.

3. Applicants must be eligible to work in Canada.

4. Businesses must plan to hire at least one employee in addition to the owner during the term of the loan guarantee.

5. Businesses must be established in Ontario and begin operations within four weeks of receiving the loan.

C. Program Administration

There are three main options for assigning the administration of the program.

Ontario Development Corporation

ODC is the financial arm of the Ministry of Industry, Trade and Technology. It administers a large portfolio of direct loans and guarantees. Legislation permits ODC to lend and guarantee loans to any type of business. Ministry and ODC board policy has limited its scope to manufacturing, tourism and related businesses.

Pro

- existing apparatus for loan administration.

Con

- tied to manufacturing and tourism clientele
- preference for direct lending

Ministry of Skills Development

The Ministry of Skills Development originated the Student Venture Capital and Youth Venture Capital Programs and currently administers them successfully. There is close coordination with the Ministry of Industry, Trade and Technology.

Pro

- operates successful YVC and SVC programs

- would keep similar programs in one organization

Con

- lack of in-house advice and counsel resources for business owners

- small business is not the prime client group of Ministry of Skills Development

Ministry of Industry, Trade and Technology

The Ministry has a full range of programs and is a centre for policy development on small business.

Pro

- existing advice and counsel programs for small business

- small business is the prime clientele

Con

- separates New Ventures Program from similar programs

D. Roles of the Co-Sponsors

The Ontario Chamber of Commerce, Local Chambers of Commerce/Boards of Trade and Business Associations:

- Consult in program design and delivery;

- Disseminate information and applications;

- Promote program in their own communities.

Approved Lenders (Chartered Banks, Trust Companies, Credit Unions and Caisses Populaires):

- Consult in program design and delivery;

- Review and assess loan applications based on criteria negotiated between the lenders and the Ministry;

- Approve loan applications in accordance with guidelines;

- Issue loans and report to Ontario government;

- Monitor approved businesses through a review process;

- Loan administration and collection during the guarantee period;

- Follow-up on compliance with loan repayment schedule;

- Provide banking advice to successful applicants.

Ministry of Industry, Trade and Technology:

- Design, promote, and administer overall program;

- Design, print and distribute brochures and application forms;

- Design screening package to help lender personnel review loan applications;

- Monitor loan applications, approvals and business status;

- Co-ordinate and follow-up with co-sponsors;

- Guarantee loans and reimburse lenders for interest costs and defaulted principal;

- Institute collection procedures by referring defaulted loans to the government's Central Collection Service;

- Follow-up and evaluate results;

- Co-ordinate education and local follow-up sessions for program participants with the local Chambers and Boards.

E. Application Process

A brochure would be prepared which would be distributed to local Chambers of Commerce, Boards of Trade, business associations, branches of the participating lenders, Canada Employment Centres, Ministry of Consumer and Commercial Relations business registration offices and

other appropriate distribution points. The brochure will specify the eligibility requirements and act as an initial screening mechanism. The brochure will include a Request for Application which can be mailed to the Ministry of Industry, Trade and Technology.

Upon receipt of a Request for Application, the Ministry will collect preliminary data on the prospective applicant and mail an Application Kit. The Application Kit will include program guidelines and procedures, the Ministry's "Starting a Small Business In Ontario," handbook, a list of lenders' branches conducting interviews and other resource material. The Application Kit will also include a personal information sheet, cash flow forecast and written business plan.

Once the Application Form has been completed, the applicant will take the form to a branch of a participating lender. After reviewing the application, the manager or loans officer will meet with the applicant to assess the business proposal. The lender will complete a Business Evaluation Form (developed and provided by the Ministry). This form will provide the lender with specific guidelines on which the application is to be judged. The lender will make a recommendation to the Ministry on approval and amount of the loan and forward the application to the Ministry.

F. Lending Procedures

As described in the eligibility critera, lenders will approve loans on a matching basis, i.e. the applicant must be prepared to put up equity equal to the approved loan (equal to 50% in the North). For example, in order to receive a $15,000 loan, the applicant must first show proof of $15,000 of initial capitalization. This will help ensure that applicants are seriously committed to establishing an ongoing enterprise.

The lender will make the final decision concerning loan approval. If an application is not approved, the lender will notify the applicant directly and advise the Ministry of the decision. Approved applicants will be notified of approval by the lender. The Ministry will be notified of loan approval by receiving a copy of the

loan agreement. It will be the lender's responsibility to arrange a time at which the participant may sign the loan agreement at the branch where the interview was conducted. Once the agreements are signed, the participant will retain one copy, the lender will keep one copy, and the final copy will be sent to the Ministry.

G. Maximum Amount of Loan

It is proposed that the maximum loan amount be $15,000 per venture.

H. Monitoring

Applicants will be required to submit a quarterly review of the business to the lender where the interview was conducted. The lender will be required to comment briefly on the business's progress and forward the review to the Ministry. Any follow-up action (including recall of the loan) resulting from a failure to report or a poor report will be initiated by the lender. This will be in addition to regular follow-up and consultation undertaken by the Ministry.

The Ministry will operate a computerized monitoring system to track the status of applications, approved loans and participating businesses. The system will provide for rapid assessment of lender performance in accordance with program guidelines.

I. Repayment

For the first 12 months, participants will pay interest only at the rate of prime plus 1%. After one year, repayment will begin with at least 60% of repayment to be completed within the next 24 months, the end of the guarantee period. At that point lenders and participants will negotiate terms of the loan and repayment on a market basis.

The lenders will be responsible for collection procedures during the loan guarantee period. Throughout this time the interest rate will be maintained at prime plus 1%.

The government will reimburse the lenders for any defaulted principal and interest payments during the guarantee period (up to 36 months after the loan was issued). The Ministry will refer all loans not paid during the guarantee period to the government's Central Collection Service.

Lenders will be permitted to vary the repayment schedule from the standard set out above during the guarantee period. For example, if the lender and participant determine that the business is progressing well and needs the full equity available to it, they could agree to reduce the rate of loan repayment. The provincial guarantee coverage would, however, continue to decline each month by an amount equal to the standard repayment schedule.

In a different situation, where the business has strong cash flow, the lender and participant could agree to accelerate repayment. For example, they could arrange for 70% of the loan to be repaid during the guarantee period rather than the standard 60%. That would leave less principal to re-negotiate at the expiry of the guarantee.

J. Lender Fee and Guarantee

The Ministry will be presented with an itemized invoice for interview and loan administration fees by the lender on a quarterly basis.

Lenders will receive a fee for the administrative efforts involved in accepting applications, interviewing applicants, and monitoring businesses. The following schedule is proposed:

- $30 screening fee for each application assessed (applicants interviewed).
- $150 for each loan approved by the government.

The Ministry will remit the invoiced amount to the lender's District/Head Office for disbursement to the branches. Principal and interest from any loan that is recalled before the guarantee term will be immediately claimed by the lender and paid out by the Ministry following a brief collection period by the lender (e.g. 30, 60 or 90 days). Any defaulted loan amount (principal plus interest) will be paid to the lender at the end of the guarantee period for the loan.

Successful loan applicants will pay a $150 administration fee to the Ministry, which may be deducted from the principal and remitted when the loan is advanced.

IV COSTS

The program will cost $12,400,000 in the first year of operation, based on issuing 7,000 loans with a total principal of $105,000,000. Based on an estimated 10% annual default rate (11% in the North and East) and 36 month guarantee period, costs stabilize in the third year of the program at about $37,000,000.

New Ventures Program
Summary of Estimated Costs, 1986-87 to 1990-91
(000's)

	1986-87	1987-88	1988-89	1989-90	1990-91
Salaries and Benefits	336	336	336	336	336
Administrative Cost (D.O.E.)	1,000	1,000	1,000	1,000	1,000
Transfer Payments (Interest, Default and Bank Fee Cost)	12,145	22,895	33,645	36,395	36,395
Sub-Total	13,481	24,231	34,981	37,731	37,731
Less: Applicant fees	- 1,050	- 1,050	- 1,050	- 1,050	- 1,050
TOTAL	12,431	23,181	33,931	36,681	36,681

V BENEFITS

The major economic benefits of the program include job creation and the growth of new companies. While the program can be justified solely on the job creation results, indications are that it would also contribute to capital investment and growth.

A recent study demonstrated how new businesses would allocate an additional $25,000 investment. The results indicated that over 40% would purchase or lease new equipment. A nearly equal number would hire staff. The following table summarizes the findings.

Use of a $25,000 Capital Investment in Small Firms

	Incorporated	Unincorporated
	%	%
Would Use Money:		
To purchase or lease equipment	41	45
To hire staff	41	40
To pay down loans	31	39
To rent or buy more space	36	42
To purchase inventory	27	34
To take part of as income	16	18

Source: The Creative Research Group Limited, 1985.

A slightly different profile came from research on the uses of the Ontario corporate income tax exemption. This provision generated cost savings of about $17,500 per firm. Business owners again stated that the most prevalent result was acquisition of equipment (48%), followed by expanding inventory (37%) and hiring staff (33%). The following table presents the findings of this study.

Results of Ontario Corporate Income Tax Exemption

	Percent
Purchased or leased equipment	48
Purchased inventory	37
Hired staff	33
Paid down loans	25
Spent money on research and development	25
Took part as income	20
Rented or bought more space	14
Average number of employees hired among those hiring more staff	
Full-time	2.9
Part-time	0.5

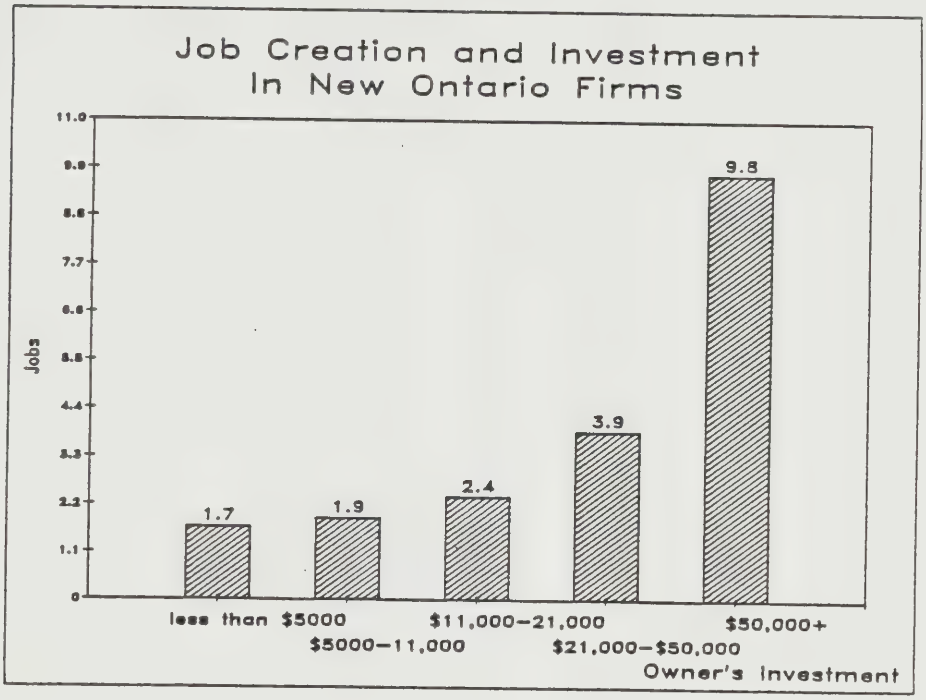
Source: The Creative Research Group Limited, 1985.

These findings indicate that the program will have significant investment benefits.

Job creation and increased sales will be the principal benefits of the program. The estimated results are based on the following assumptions:

- 1.5 incremental jobs per firm;
- additional sales at the rate of $30,000 per employee;
- provincial revenue at 15% of related increase in Gross Provincial Product.

The same study found a positive connection between start-;up investment and job creation in new small businesses. As shown in the following chart, firms started with $11,000 to $21,000 equity had 2.4 employees on average; those capitalized at $21,000 to $50,000 had 3.9 employees. Thus, the extra capital provided through the New Ventures Program will lead to an incremental 1.5 jobs per firm.



Total employment in the 7,000 new firms to be financed each year will be about 21,000 jobs. Their sales will reach over $600 million yearly. The related provincial revenue will be nearly $44 million.

The anticipated results of the New Ventures Program for each year of operation are:

- 7,000 firms assisted;
- 10,500 incremental jobs;
- $315 million incremental sales;
- $105 million private lender financing;
- $25 million in loans set aside for Northern and Eastern Ontario businesses;
- $92.5 million matching investment;
- $22 million incremental provincial revenue.

The program will develop self-discipline among participating business owners through strong emphasis on business planning at the application stage and financial reporting through the term of the loan. Measurable improvement in the survival and growth of new firms will result from the linkage of better access to capital and management upgrading.